

Alan F. Ciamporcero
Executive Director

Federal Regulatory Relations
1275 Pennsylvania Avenue, N.W., Suite 400
Washington, D.C. 20004
(202) 383-6416

PACIFIC  TELESIS
Group-Washington

RECEIVED

1 APR 17 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

April 17, 1995

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, DC 20554

DOCKET FILE COPY ORIGINAL

Dear Mr. Caton:

Re: *CC Docket No. 94-1, Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation*

On behalf of *Pacific Bell*, please find enclosed an original and six copies of its "*Comments*" in the above proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,



Enclosure

No. of Copies rec'd
List ABCDE



Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

RECEIVED

APR 17 1995

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Price Cap Performance Review
for Local Exchange Carriers;
Treatment of Video Dialtone Services
Under Price Cap Regulation

CC Docket No. 94-1

DOCKET FILE COPY ORIGINAL

COMMENTS

Pacific Bell respectfully submits these Comments on the Commission's tentative conclusions on a separate price cap basket for video dialtone services.¹

Pacific Bell opposes including video dialtone (VDT) services in price cap regulation. The Commission intended VDT as a competitive alternative to entrenched cable television services. VDT service should be constrained by the discipline of the marketplace, not the Commission. Price cap regulation, with its attendant price controls, will hamper or deter the rapid development of a competitive alternative to monopoly cable providers.

If the Commission affirms its tentative conclusion to include VDT services in price cap regulation, it should minimize regulatory constraints and let an offering develop that responds to market signals. We therefore recommend that for price cap LECs that opt for a no-sharing price cap plan, VDT should be excluded from price caps. For other LECs, considerable pricing flexibility is needed to let VDT respond to market signals. Either VDT should be

¹ Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation, CC Dkt. No. 94-1, Further Notice of Proposed Rulemaking, FCC 95-49, February 15, 1995 (Further NPRM).

excluded from price cap regulation for a substantially longer period of time than other new services, or, if it is included in price caps after the customary period, considerable pricing flexibility must be permitted until the marketplace has indicated the optimal price. A VDT basket should have no service bands.

No productivity factor should apply to VDT. In addition, for price cap LECs who opt for the price cap sharing plan, the VDT basket results should be included with the results of other baskets.

I. Price Cap Regulation Is Not Appropriate For VDT.

The Commission's overarching goals for telephone company involvement in the video marketplace included "increasing competition in the video marketplace."² VDT will compete with incumbent monopoly cable services. The Commission said that VDT would "foster additional competition in the video and communications markets, so that free market forces, rather than governmental regulation, determine the success or failure of new services".³

Price cap regulation is intended to "mirror ... the efficiency incentives found in competitive markets."⁴ Price cap regulation is therefore a *substitute* for competition. It is of no value where competition already exists. On this basis the Commission has removed AT&T's competitive services from price cap regulation.⁵

² Telephone Company-Cable Television Cross Ownership Rules, Sections 63.54 - 63.58, Second Report and Order, Recommendation to Congress, and Second Further Notice of Proposed Rulemaking, 7 FCC Rcd. 5781 (1992) ("Video Dialtone Order"), para. 1; 10 FCC Rcd. 244 (1994) ("VDT Reconsideration Order"), para. 3.

³ Video Dialtone Order, para. 9.

⁴ Policy and Rules Concerning Rates for Dominant Carriers, 5 FCC Rcd. 6786, para. 33 (1990).

⁵ See for example Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, Notice of Proposed Rulemaking, FCC 93-327, released July 23, 1993.

While price cap regulation is undoubtedly an improvement over rate of return regulation, it is still a system of price and output controls. Goals such as promoting economic efficiency, ensuring reasonable nondiscriminatory rates, and reducing administrative costs (Further NPRM, para. 8) are not advanced by subjecting a competitive service to such controls. Price controls on a competitive product destroy consumer welfare by distorting signals of supply and demand. In plain English this means consumers either pay too much or get too little.

The Commission proposes to “help prevent improper cross-subsidization by preventing local telephone companies from offsetting a price reduction for video dialtone service with an increase in rates for other regulated interstate services,” by subjecting VDT services to price cap regulation and putting them in a separate basket. (Further NPRM, para. 8.) But to the degree that there is any incentive for “improper cross-subsidization” between VDT and “other regulated interstate services”, it justifies *excluding* VDT services from price cap regulation, not putting them in a separate basket. As the D.C. Circuit has observed, in a price cap plan without sharing, there is no “reward for shifting costs from unregulated activities into regulated ones, for the higher costs will not produce higher legal ceiling prices.”⁶

The Commission has recently adopted new price cap rules that will eliminate sharing for carriers on the condition they subject themselves to a productivity factor (5.3%) that is higher than any methodologically sound study supports.⁷ Commissioner Barrett expressed concern “whether we have provided a realistic incentive for companies to move to this [no sharing] option ... especially to the extent that companies may question the likelihood of

⁶ *National Rural Telecom Ass’n v. FCC*, 988 F.2d 175, 178 (D.C. Cir. 1993).

⁷ “Commission Affirms Commitment to Competition and Fair Long Distance Rates in LEC Price Cap Plan”, News Release, Report No. DC 95, released March 30, 1995.

sustaining this level [5.3%] of productivity.”⁸ Even Commissioner Ness, dissenting, expressed the importance of eliminating sharing.⁹

We submit that in this proceeding the Commission could both preclude any potential for “improper cross-subsidization,” *and* create an important additional incentive for carriers to opt for the no-sharing plan, by excluding from price caps the VDT services of carriers who choose not to be subject to sharing. Like other common carrier services that are excluded from price cap regulation today, VDT services would continue to be subject to Title II requirements, as well as the whole panoply of the Commission's enforcement powers. This is more than enough to guard against unjust rates or unreasonable discrimination.

The constraints of price caps also conflict with other significant goals of the Commission for VDT, including “creating opportunities to develop an advanced telecommunications infrastructure and enhancing the diversity of video services to the American public.”¹⁰ Carriers have a disincentive to create new services when they know that once created the services would immediately be subject to price controls, in fact, that they might not receive permission to offer them at all.

The availability of VDT will probably result in removing cable offerings from rate regulation.¹¹ If VDT is subject to price caps, the Commission will have created an anomaly: VDT rates would be regulated but cable rates probably would not be. If VDT is included under

⁸ *Id.*, Separate Statement of Commissioner Andrew C. Barrett, p. 4.

⁹ *Id.*, Dissenting Statement of Commissioner Susan Ness, p. 5.

¹⁰ Video Dialtone Order, para. 1.

¹¹ Cable rate regulation applies only if there is no effective competition. See 47 U.S.C. Section 543.

price caps, the Commission must make clear that VDT will be removed from price cap regulation when there is effective competition (*i.e.*, cable offerings are removed from rate regulation).

II. VDT Services Should Enjoy Considerable Pricing Flexibility.

VDT is unlike the other services subject to price caps. The expected demand for VDT has been sharply debated, even among the LECs, and may continue to be debated for quite some time.¹² The regulatory process itself, which will determine the terms, conditions, and price under which VDT may be offered, contributes to the uncertainty of demand.

Setting the initial price cap. New services are ordinarily excluded from price cap regulation for just one annual access filing, both to “strengthen carrier incentives to innovate” and “to enable LECs to develop the historical demand figures we require for computation of our price cap formulas.”¹³ In the case of VDT, this short period will not be long enough to serve either purpose. We therefore suggest that if VDT is subject to price caps, it should be excluded from price cap regulation for a substantially longer time than other new services--such as three to five years. There can be little doubt that the more early pricing flexibility we have, the more rapidly the service will be deployed and subscribed to. It has nothing to do with “improper cross-subsidization” and everything to do with recovering our start-up costs, determining the pricing strategy (which at this point is still largely unknown) that will grow the market fastest and thus return the most value to subscribers, and gaining the cost, demand, and market

¹² See Letter from Alan F. Ciamporzero to William F. Caton, Acting Secretary, Federal Communications Commission, January 13, 1995, pp. 4-8; Letter from Alan F. Ciamporzero to Kathleen M. H. Wallman, Chief, Common Carrier Bureau, Federal Communications Commission, March 21, 1995.

¹³ 5 FCC Rcd. 6786, para. 319.

experience without which it is impossible to say what a “just and reasonable” price for the product would be.

There is not a single argument for subjecting VDT to regulation-as-usual that could not have been made for regulating cellular service when it first became practicable. Yet there can be little debate that if cellular--for which demand was equally uncertain at first--had been regulated “like other regulated interstate services”, consumers would have been harmed in the long run by paying artificially set prices, and cellular penetration would be lower today.

VDT must be permitted a liberal amount of pricing flexibility. Because it is interactive, the value of the VDT network will increase exponentially as each provider or subscriber is added to it. Thus from a public policy standpoint the best pricing strategy for VDT services may be an initially low price to encourage connection to the VDT network, then a rising price to reflect the increasing value of the network as connection becomes more widespread. Conventional price cap regulation, with little upward or downward flexibility for basket PCIs, would not permit such a public policy to be realized. In addition, as NCTA itself said, “In any capital-intensive business, costs are very high in early years and lower in later years (as the investment is depreciated). A strict year-by-year cost analysis would lead to very high initial rates and very low rates in later years. This pricing approach makes no sense in the marketplace, and regulators do not require it of telephone companies.”¹⁴

Service Category Bands. If included in price caps, the VDT basket should not have service bands. All VDT offerings will be competitive. Regulation should not seek to deter price discrimination between competitive services. The goal of deterring “price discrimination”

¹⁴ See Ex Parte of NCTA, MM Docket No. 93-215, filed March 10, 1995.

sounds laudable, but it founders on the law of unintended consequences. In markets where consumers have choices, a prohibition on price discrimination, like any other price control, destroys consumer welfare. The consequence of any decree that all flyers pay the same fare, or that all hotel guests pay the same rate, is that more airplanes will fly with empty seats, more hotel rooms will stand vacant, and everybody will pay full price. Price bands within a VDT basket are an example of the kind of cumbersome regulation that will chill innovation and conflict with the goal of stimulating new alternatives to entrenched cable monopolists.

Finally, the VDT basket should not include “other broadband, transport-related services” (Further NPRM, para. 12) merely because of technical similarity. It should only include services that can be demonstrated to have a high degree of cross-elasticity with VDT services.

III. There Is No Record Support for a VDT Productivity Factor.

No productivity offset should apply to VDT. There is no record support for any factor. The studies conducted of interexchange and access services are no substitute, because these services cannot substitute for VDT.¹⁵ There is simply no history of a common carrier multiple access, nondiscriminatory offering for video services upon which to base any decision for choosing a factor.

The Commission has never previously established a productivity factor without empirical evidence. As it stated in Docket 93-215:

¹⁵ See 5 FCC Rcd. 6786, paras. 13, 207, fn. 239. Presubscription change charges, for example, were excluded from price caps because “[t]hese charges are very different from the broader system of interstate access offerings that have been studied at length to determine LEC productivity” (Id., para. 195), which is true of VDT as well.

A productivity offset should be based to the extent possible on observed efficiency gains experienced by the cable industry.... In adopting a productivity offset in other contexts, the Commission has had the benefit of numerous Commission-sponsored and independent economic studies, each providing a record of the historical costs and productivity of the relevant industry.

We believe that the current record does not provide an adequate factual basis for the incorporation of a productivity offset into the price cap governing cable service rates.¹⁶

No such evidence exists, or will exist in the near future for VDT.

A Consumer Productivity Dividend ("CPD") is unnecessary for a competitive service. The purpose of the CPD was to keep prices low. Because video dialtone will be competitive with entrenched cable offerings, video dialtone providers will have a natural incentive to make prices attractive to the marketplace. Moreover, the absence of empirical evidence upon which to determine a productivity factor means that there is no evidence to use to determine a CPD.

IV. VDT Basket Earnings Should Be Treated the Same as Other Basket Earnings.

The Commission suggests that earnings from VDT services should not be included in the calculation of a LEC's interstate rate of return for purposes of sharing and the low end adjustment mechanism, because "[i]nclusion of these costs and revenues will change a LEC's earnings whenever the return earned on video dialtone is different from the return on other interstate services." (Further NPRM, para. 25.) The Commission then refers to its goal of deterring "unreasonable rate increases or improper cross-subsidization." (Id.)

¹⁶ Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 - Rate Regulation, MM Docket No. 93-215, Memorandum Opinion and Order, FCC 94-226 (released September 29, 1994), paras. 6-7.

The apparent premise behind these statements is false. If the profits from one profitable service are blended with the profits from another profitable service, both services have recovered their costs. Cross-subsidization does not occur unless the *costs* of a service are recovered from the customers of a different service.¹⁷ Even then, the cross-subsidization is not improper unless one service is competitive and the other is a monopoly. Any other theory of “improper cross-subsidization” would deem “improper” the vast majority of economic activity in this country, because most firms offer more than one service, and reinvest the combined profits without regard to their source.

The Commission can find that VDT is an “essential service”, or it can find that “improper cross-subsidization” between VDT and telephone services is a threat, but it is irrational to find both. If the Commission remains in doubt about this point, it can resolve that doubt by excluding VDT from price caps, which would end the “cross-subsidy” debate by precluding *cost* shifts between VDT and telephone services.

V. Conclusion

We respectfully suggest:

(1) For price cap LECs that opt for a no-sharing price cap plan, VDT should be excluded from price caps.

(2) For other LECs, considerable pricing flexibility is needed to let VDT respond to market signals. Either VDT should be excluded from price cap regulation for a substantially longer period of time than other new services, or, if it is included in price caps after the

¹⁷ See n.6 above.

customary short period, considerable pricing flexibility must be permitted until the marketplace has indicated the optimal price. A VDT basket should have no service bands.

(3) No productivity factor should apply to VDT.

(4) For price cap LECs who opt for a price cap sharing plan, the VDT basket results should be included with the results of other baskets.

Respectfully submitted,

PACIFIC BELL



JAMES P. TUTHILL
LUCILLE M. MATES
JOHN BOGY

140 New Montgomery Street, Rm. 1526
San Francisco, California 94105
(415) 542-7654

JAMES L. WURTZ
MARGARET E. GARBER

1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004
(202) 383-6472

Its Attorneys

Date: April 17, 1995